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Gifts, Income From Trusts and Estates, and Life Insurance

- Gifts and inheritances are not taxed. However, income earned from investing gifts or inherited property is taxable. You also may receive a gift in the form of trust income. The trust income is taxable as explained in this chapter.
- Life insurance proceeds received on the death of a person are usually tax free, although interest earned on the proceeds received as installments is generally taxed.
- Tax accounting for trust or estate income is complicated. As a beneficiary, you are not required to understand the rules governing the taxing of trusts and estates. That is the trustee's or executor's responsibility. The fiduciary should inform you of your share of taxable income and its source on Schedule K-1 of Form 1041. The fiduciary should also tell you whether the distribution is out of current income or accumulated income.

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Gifts, Inheritances, and Trust and Estate Income

¶11.1 Gifts and Inheritances

Gifts and inheritances you *receive* are not taxable. Income earned from gift or inherited property after you receive it is taxable.

Describing a payment as a gift or inheritance will not necessarily shield it from tax if it is, in fact, a payment for your services. Treatment of gifts to employees is covered at ¶2.4.

EXAMPLES

1. An employee is promised by his employer that he will be remembered in his will if he continues to work for him. The employer dies but fails to mention the employee in his will. The employee sues the estate, which settles his claim. The settlement is taxable.
2. A nephew left his uncle a bequest of $200,000. In another clause of the will, the uncle was appointed executor, and the bequest of the $200,000 was described as being made in lieu of all commissions to which he would otherwise be entitled as executor. The bequest is considered tax-free income. It was not conditioned upon the uncle performing as executor. If the will had made the bequest contingent upon the uncle's acting as executor, the $200,000 would have been taxed.
3. An attorney performed services for a friend without expectation of pay. The friend died and in his will left the attorney a bequest in appreciation for his services. The payment was considered a tax-free bequest. The amount was not bargained for.
4. A lawyer agreed to handle a client's legal affairs without charge; she promised to leave him securities. Twenty years later, under her will, he inherited the securities. The IRS taxed the bequest as pay. Both he and the client expected that he would be paid for legal services. If she meant to make a bequest from their agreement, she should have said so in her will.

A sale of an expected inheritance from a living person is taxable as ordinary income.

Gifts you make. You may have to file a gift tax return if your gifts to an individual within the year exceed $10,000; *see* ¶33.1.

Campaign contributions. Campaign contributions are not taxable income to a political candidate if the funds are used for political campaign expenses or some similar purposes. Detailed records of receipts and disbursements are advisable to avoid tax on the political funds. Also nontaxable are contributions that are intended for the candidate's unrestricted personal use and qualify as gifts.

¶11.2 How Beneficiaries Report Estate or Trust Income

Trust or estate income is treated as if you had received the income directly from the original source instead of from the estate or trust. This means capital gain remains capital gain, ordinary income is fully taxed, and tax-exempt income remains tax free. Tax preference items of a trust or estate are apportioned between the estate or trust and beneficiaries, according to allocation of income; *see* ¶23.5.

You report your share of trust or estate income as shown on the Schedule K-1 (Form 1041) sent to you by the trustee. Dividends and interest from the trust are reported on Schedule B of Form 1040 and capital gains on Schedule D. Income or loss from real estate or business activities shown on Schedule K-1 is reported by you on Schedule E, subject to the passive activity restrictions discussed in Chapter 10.

Reporting rule for revocable grantor trusts. A grantor who sets up a revocable trust or keeps certain powers over trust income or corpus must report all of the trust income, deductions, and credits. This rule applies if a grantor retains a reversionary interest in the trust that is valued at more than 5% of the trust (valued at the time the trust is set up); *see* ¶33.6. If a grantor is also a trustee of a revocable trust and all the trust assets are in the United States, filing Form 1041 is not necessary. The grantor simply reports the trust income, deductions, and credits on Form 1040. This reporting rule is optional for revocable trusts created before 1981. Grantors of such trusts who want to report trust income on their own returns without having to file Form 1041 must first file a final Form 1041 for the current tax year with a notation on the form alerting the IRS that in later years they will report trust income on their own returns; *see* the instructions to Form 1041.

¶11.3 Distributions of Accumulated Trust Income

Where you are the beneficiary of an accumulation trust, the trust accumulates income on which it pays tax. When the trust distributes income to you, the trustee tells you what part of the distribution is attributable to accumulations of prior income. The tax on an accumulation distribution is figured on Form 4970. Distributions of current income are reported according to the rules of ¶11.2. If you receive a distribution of accumulated income from a trust, contact the trustee or an experienced tax practitioner for advice in computing your tax on the accumulation.

Distributions of accumulated income are subject to tax, provided the accumulation exceeds the distributable net income of the trust for the year. However, under the throwback rule, only that portion of

the accumulation distribution that would have been included in the beneficiary's income had it been distributed when earned is currently taxed. Thus, tax-exempt interest is never taxed. Income accumulated prior to the beneficiary's reaching the age of 21 and the years before a beneficiary was born is not subject to the throwback rule unless distributions are made under a multiple trust rule explained in the instructions to Form 4970.

Although a beneficiary pays a tax in the year of receiving the accumulation distribution, tax is computed as if the accumulated income were actually distributed in the years in which it was earned. For the year of the accumulation distribution, the beneficiary pays tax on the sum of: (1) a tax on taxable income exclusive of the accumulation distribution; (2) a tax on the accumulation distribution computed using a short-cut method that takes into account taxable income in three of the five years preceding the year of distribution; and (3) an interest charge in the case of a foreign trust.

In preparing your return, the tax on your regular taxable income is computed on Form 1040; the tax on the distribution is computed on Form 4970 and added to the tax on Form 1040.

Where a trust has already been subject to estate tax or the generation-skipping transfer tax, the partial tax on a distribution is reduced by the estate or generation-skipping tax attributable to the accumulated income. The reduction is limited by a special statutory formula for determining the pre-death portions.

Where the beneficiary receives an accumulation distribution from more than two trusts for the same year, tax for the distributions from the third trust is computed under the method described above, except that no credit is given for any taxes previously paid by the trust with respect to the accumulation distribution. A *de minimis* rule provides that accumulation distributions are not subject to the multiple trust rule unless the distribution equals or exceeds $1,000.

Trust sale of capital gain property within two years of transfer. Capital gain is not subject to the throwback rules. However, if the trust sells appreciated property within two years of receiving it by gift or bargain sale, gain is taxed at the same rate that the grantor would have paid if the grantor sold the property. This rule for taxing gain does not apply if following the grantor's death the trust sells in the two-year period.

Trust for the benefit of a spouse. Where a spouse creates a trust for the benefit of the other spouse, income of the trust is taxed to the spouse who created the trust as income is earned. Trust transfers before October 10, 1969, are not subject to this rule.

¶11.4 Deductions for Income Subject to Estate Tax

If you receive income which was earned by, but not paid to, a decedent before death, you are said to have "income in respect of a decedent." You report the income, and if an estate has paid a federal estate tax on the income, you may deduct part of the estate tax allocated to the income. No deduction is allowed for state death taxes. Ask the executor of the estate for data in computing the deduction.

EXAMPLE

When Jim Bennett's uncle died, he was owed a fee of $1,000. He also had not collected accrued bond interest of $500. Bennett, as the sole heir, will collect both items and pay income tax on them. These items are called income in respect of a decedent. Assume that an estate tax of $390 was paid on the $1,500. Bennett collects the $1,000, which he reports on his income tax return. He may deduct $260, computed as follows:

$$\frac{\$1{,}000}{\$1{,}500} \times \$390, \text{ or } \$260$$

When he collects the $500, he will deduct the balance, or $130 ($390 – $260).

The deduction is generally claimed as a miscellaneous itemized deduction that is *not* subject to the 2% AGI floor; *see* Chapter 19. However, if you receive long-term capital gain income, such as an installment payment on a sale transacted before a decedent's death, the estate tax attributed to the capital gain item is not claimed as a miscellaneous deduction. The deduction is treated as if it were an expense of sale and, thus, reduces the amount of gain.

Lump-sum distributions from qualified retirement plans. When a beneficiary receiving a lump-sum distribution because of an employee's death reports the distribution using the special averaging method (Chapter 7), the taxable amount of the distribution must be reduced by the estate taxes attributable to the distribution. *See* the Form 4972 instructions when calculating the tax under averaging.

Life Insurance and Other Insurance Proceeds

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¶11.5 How Life Insurance Proceeds Are Taxed to a Beneficiary

Life insurance proceeds received upon the death of the insured are generally tax free. However, insurance proceeds may be subject to estate tax so that the beneficiary actually receives a reduced amount; *see* ¶39.2.

Interest paid on proceeds left with the insurer is taxable except in this case: A surviving spouse who elects to receive installments rather than a lump sum does not pay tax on the first $1,000 of interest received each year if the decedent died before October 23, 1986.

Read the following checklist to find how your insurance receipts are taxed—

A lump-sum payment of the full face value of a life insurance policy: The proceeds are generally tax free. The tax-free exclusion also covers death benefit payments made under endowment contracts, workers' compensation insurance contracts, employers' group insurance plans, or accident and health insurance contracts. The exclusion does not apply to a policy combined with a nonrefund life annuity contract where a single premium equal to the face value of the insurance is paid.

Insurance proceeds may be taxable where the policy was transferred for valuable consideration. Exceptions to this rule are made for transfers among partners and corporations and their stockholders and officers.

Installment payments spread over your life under a policy that could have been paid in a lump sum: Part of each installment attributed to interest may be taxed. Divide the face amount of the policy by the number of years the installments are to be paid. The result is the amount which is received tax free each year.

If you are the surviving spouse of an insured who died before October 23, 1986, up to $1,000 of interest paid with the annual installment is also tax free. You are still treated as a spouse if separated from the insured at the date of his or her death, but not if divorced. (If you receive payments under a policy with a "family income rider," *see* ¶11.6.) The $1,000 interest exclusion is not allowed where the insured died after October 22, 1986.

EXAMPLE

Alice is the wife and beneficiary under her husband John's life insurance policy of $100,000. He died September 30, 1986. She elected to take installment payments for the rest of her life. Alice's life expectancy is 20 years. Then $5,000 ($100,000 ÷ 20) is the principal amount spread to each year. The first $6,000 received each year ($5,000 principal plus $1,000 of the spouse's special interest exclusion) is exempt from tax. If Alice lives more than 20 years, she may continue to treat up to $6,000 of annual payments as tax-free receipts.

If the policy guarantees payments to a secondary beneficiary if you should die before receiving a specified number of payments, the tax-free amount is reduced by the present value of the secondary beneficiary's interest in the policy. The insurance company can give you this figure.

Installment payments for a fixed number of years under a policy which could have been paid in a lump sum. Divide the full face amount of the policy by the number of years you are to receive the installments. The result is the amount which is received tax free each year.

EXAMPLE

Same facts as in the preceding Example, but Alice elects to take installment payments for 10 years. Then $10,000 ($100,000 ÷ 10) is the principal amount received tax free. So up to $11,000 per year may be received tax free by Alice, $10,000 of principal sum plus up to $1,000 of interest, under the surviving spouse's interest exclusion.

Installment payments when there is no lump-sum option in the policy: You must find the discounted value of the policy at the date of the insured's death and use that as the principal amount. The insurance company can give you that figure. After you find the discounted value, you divide it by the number of years you are to receive installments. The result is the amount that is tax free. The remainder is taxed.

EXAMPLE

The insured died in 1996. Under an insurance policy, the surviving wife is entitled to $5,000 a year for life. Her life expectancy is 20 years. There is no lump sum stated in the policy. Say the discounted value of the wife's rights is $60,000. The principal amount spread to each year for the wife is $3,000 ($60,000 ÷ 20). Subtracting $3,000 from each annual $5,000 payment gives her taxable income of $2,000.

Payments to you along with other beneficiaries under the same policy, by lump-sum or varying installments.

EXAMPLE

Under one life insurance policy of an insured man who died in 1996, a surviving wife, daughter, and nephew are all beneficiaries. The wife is entitled to a lump sum of $60,000. The daughter and nephew are each entitled to a lump sum of $35,000. Under the installment options, the wife chooses to receive $5,000 a year for the rest of her life. (She has a 20-year life expectancy.) The daughter and the nephew each choose a yearly payment of $5,000 for 10 years. This is how each yearly installment is taxed:

WIFE: The principal amount spread to each year is $3,000. Subtracting $3,000 from the yearly $5,000 payment gives the wife taxable income of $2,000.

DAUGHTER AND NEPHEW: Both are taxed the same way. The principal amount spread to each of the 10 years is $3,500. Subtracting this $3,500 from the yearly $5,000 installment gives the daughter and the nephew taxable income of $1,500 each.

Interest only option. When proceeds are left on deposit under the "interest only" option, the interest is fully taxed; the lump sum is not taxed. A surviving spouse of an insured who died before October 23, 1986, may not exclude $1,000 interest under the "interest only" option. However, if the surviving spouse later elects to receive proceeds from the policy in installments, the interest exclusion applies from the time of the election.

Universal life policy. A universal life policy allows a policyholder to apply premium payments to cash value instead of to death benefits. Death benefits may be tax free if the policies meet certain technical tests. These tests must be determined by the insurance company. Therefore, you must check with the company paying the proceeds as to whether the payments qualify as tax-free life insurance payments.

Other names applied to universal life may be "flexible premium" or "adjustable life premium" policies.

¶11.6 A Policy With a Family Income Rider

Payments received under a family income rider are taxed under a special rule. A family income rider provides additional term insurance coverage for a fixed number of years from the date of the basic policy. Under the terms of a rider, if the insured dies at any time during the term period, the beneficiary receives monthly payments during the balance of the term period, and then at the end of the term period, receives the lump-sum proceeds of the basic policy. If the insured dies after the end of the term period, the beneficiary receives only the lump sum from the basic policy.

When the insured dies during the term period, part of each monthly payment received during the term period includes interest on the lump-sum proceeds of the basic policy (which is held by the company until the end of the term period). That interest is fully taxed. The balance of the monthly payment consists of an installment (principal plus interest) of the proceeds from the term insurance purchased under the family income rider. You may exclude from this balance: (1) a prorated portion of the present value of the lump sum under the basic policy; and (2) an additional amount of up to $1,000 attributable to interest if you are a surviving spouse of an insured who died before October 23, 1986. The lump sum under the basic policy is tax free when you eventually receive it.

The rules here also apply to an integrated family income policy and to family maintenance policies, whether integrated or with an attached rider.

In figuring your taxable portions, ask the insurance company for its interest rate and the present value of term payments.

¶11.7 How Other Insurance Proceeds Are Taxed

Dividends paid by the insurance company as reduction of premiums (taken in cash, left as interest with the company, or used to accelerate the maturity of the policy) are not taxable. They serve to reduce the cost basis of your policy, thus increasing gain sometimes computed upon maturity of some policies. However, interest on such "dividends" is generally taxable, although the interest on GI insurance dividends left on deposit with the VA is tax free.

Matured endowment policies. You generally report as income the difference between the proceeds received and your investment; *see* ¶7.24. The payment on an endowment contract because of the insured's death is treated as the payment of tax-free life insurance proceeds provided the policy meets certain technical definitions not discussed in this book.

Sale of an endowment contract before maturity. Taxed as ordinary income; *see* ¶7.22.

Surrender of policy for cash. Taxed as ordinary income (not capital gain) if the cash received exceeds the premiums paid, less dividends received. If you take, instead, a paid-up policy, you may avoid tax; *see* ¶11.8. You get no deduction if there is a loss on the surrender of a policy.

Collection of proceeds on policy purchased by or assigned to you on the life of someone else. Where a policy is transferred for valuable consideration, only the amount paid and the premiums paid after the transfer are tax free when collected; the balance is taxed. There is no tax on life insurance proceeds paid under contracts which have been transferred to a partner or to a corporation in which the insured was a shareholder or officer.

¶11.8 Tax-Free Exchanges of Insurance Policies

These exchanges of insurance policies are considered tax free—

Life insurance policy for another life insurance policy, endowment policy, or an annuity contract.

Endowment policy for another endowment policy that provides for regular payments beginning no later than the date payments would have started under the old policy, or in exchange for an annuity contract.

Annuity contract for another annuity contract with identical annuitants.

These exchanges are not tax free—

Endowment policy for a life insurance policy, or for another endowment policy that provides for payments beginning at a date later than payments would have started under the old policy.

Annuity contract for a life insurance or endowment policy.

Transfers of life insurance contracts where the insured is not the same person in both contracts. The IRS held that a company could not make a tax-free exchange of a key executive policy where the company could change insured executives as they leave or join the firm.

Financially troubled insurer. If your annuity contract or insurance policy is with an insurance company that is in a rehabilitation, conservatorship, insolvency, or a similar state proceeding, you may surrender the policy and make a tax-free reinvestment of the proceeds in a new policy with a different insurance company. The transfer must be completed within 60 days. If a government agency does not allow you to withdraw your entire balance from the troubled insurance company, you must assign all rights to any future distributions to the issuer of the new contract or policy. Full details are in IRS Revenue Procedure 92-44.

¶11.9 Accelerated Death Benefit Payments to Terminally Ill Persons

A person who is terminally ill may be forced to cash in a life insurance policy to pay medical bills and other living expenses. With the increase of terminally ill patients, especially those suffering from AIDS, and the high cost of medical care, insurance companies have developed life insurance policies with accelerated death benefit clauses. Where a policy lacks an accelerated payment clause, it is also possible to sell a life insurance policy to a viatical settlement company that specializes in buying policies from ill persons who require funds to pay expenses.

Tax treatment. Starting in 1997, a new law provides tax-free treatment for accelerated death benefits and viatical settlement proceeds received by terminally ill individuals. Tax-free benefits for chronically ill individuals are limited. *See* the Supplement for new law details.

Under pre-1997 law, accelerated death benefits and viatical settlement sales proceeds were subject to tax. The IRS had proposed regulations, never finalized, which would have allowed terminally ill individuals to receive certain accelerated death benefits tax free. The proposed regulations did not apply to viatical settlements.